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No. 06-439

IN THE

Supreme Court of the United States

JERRY SUMMERS, GEORGE T. LENORMAND, JEFFERY D. CRITES, LOUISE VAN RENSBURG and JAMES E. SHAMBO, individually and on behalf of all others similarly situated,

Petitioners,

v.

STATE STREET BANK & TRUST COMPANY,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF

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INTRODUCTION

The central legal issue in *dozens* of currently-pending cases is the question of when the fiduciaries of employee stock ownership plans ("ESOPs") have a duty to reduce plan holdings of employer stock pursuant to the Employee Retirement Income Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001 *et seq.* *See* Petition at 21-22 (collecting cases). The Courts of Appeals are divided on the question, although most have followed *Moench v. Robertson*, 62 F.3d 553, 571-72 (3d Cir. 1995), which holds that "the plaintiff may overcome that presumption [that an ESOP fiduciary who invests the assets in employer stock acted consistently with ERISA] by establishing that the fiduciary abused his discretion by investing in employer securities."

In the instant case, however, the Seventh Circuit added greatly to the confusion surrounding the duties of ESOP fiduciaries by becoming the first court to hold that there can never be a duty to sell company stock unless (i) the stock does not trade in an "efficient market" and (ii) the fiduciary has conducted a participant-by-participant analysis and determined that the ESOP participants' other sources of income or retirement savings are not sufficient to warrant the absorption of increased risk in the ESOP investment. *Summers v. State Street Bank & Trust Co.*, 453 F.3d 404, 409-411 (7th Cir. 2006). Not only is the Seventh Circuit's standard a radical departure from the *Moench* standard, but, as the Seventh Circuit admits, its standard "may be beyond the practical capacity of the courts" to apply. *Id.* at 411. Surely Congress could not have intended such a result in a statute that is widely recognized to impose the "highest [obligations] known to law" on fiduciaries.[1]

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1. *See, e.g.*, *Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir. 1982) (Friendly, J.); *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 294 (5th Cir. 2000); *Chao v. Hall Holding Co.*, 285 F.3d 415, 426 (6th Cir. 2002); *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir. 1996); *ITPE Pension Fund v. Hall*, 334 F.3d 1011, 1013 (11th Cir. 2003).

In its effort to evade this Court's review, State Street erroneously asserts that "the petition is procedurally defective because it improperly requests the Court to affirm a lower court ruling. . . ." Resp. Br. at 9. To the contrary, Petitioners ask this Court to ***reverse*** the lower courts' grant of summary judgment in State Street's favor. Indeed, under the appropriate standard (which would ***not*** consider ESOP participants' non-plan assets), Plaintiffs/Petitioners are entitled to a trial on the question of whether State Street was obliged to act ***before*** the stock became virtually worthless.[2]

Next, State Street contends that this Court should not consider upholding the Seventh Circuit's ruling that "directed trustees" have the same co-fiduciary and fiduciary duties as other fiduciaries since the argument "was not raised below." Resp. Br. at 12-13. State Street's contention makes no sense: the Seventh Circuit's ruling is reviewable by this Court regardless of whether Petitioners raised the issue. In any event, Petitioners ***did*** argue below that (i) State Street, as the ESOP's trustee, was a fiduciary subject to the duties of prudence and loyalty pursuant to 29 U.S.C. § 1104(a); and (ii) State Street was also subject to the same co-fiduciary duties of loyalty as all other fiduciaries pursuant to 29 U.S.C. § 1105(a)(3).[3]

Finally, State Street contends that that Seventh Circuit's decision in *Summers* should not be reviewed because it "is consistent with . . . the position of the Department of Labor" ("DOL") that there can be no duty to sell until bankruptcy is a certainty. Resp. Br. at 17. To the contrary, the *Summers* court

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2. Only at that time, in the late summer of 2002, did State Street ***finally*** confront the ESOP Committee with its patent and ongoing breach of fiduciary duty – at which point State Street was almost ***immediately*** appointed as investment manager with the explicit power to begin diversifying the ESOP's holdings of UAL stock. *See* R. Doc.# 178, Plfs' Add'l Facts, ¶¶ 156, 167 and R.Doc.# 184, Plfs. Ex. 25 at UAL-SUM 00047, 00080.

3. *See, e.g.*, Plaintiffs-Appellants', Cross-Appellees' Brief and Short Appendix in Case No. 05-4005 (Seventh Circuit) at 26.

explicitly ***rejected*** the DOL's new position, finding that the DOL's standard "is not an administrable" one, and that "selling when bankruptcy is declared will almost certainly be too late." 453 F.3d at 411.

In short, the Seventh Circuit's decision in this case (i) creates a Circuit split as to the duties of ESOP fiduciaries and (ii) adds to the Circuit split as to the duties of so-called "directed trustees." Both issues are in need of resolution by this Court.

ARGUMENT

A. The Seventh Circuit's New Standard Creates A Conflict Concerning The Obligations Of ESOP Fiduciaries When The Company Is Collapsing

Prior to this case, the Courts of Appeals were generally in agreement that, depending upon the surrounding circumstances of the company whose stock is at issue, ESOP fiduciaries can have a duty to begin diversifying the plan's company stock holdings. *See, e.g., Moench v. Robertson*, 62 F.3d 553, 571-72 (3d Cir. 1995); *accord LaLonde v. Textron, Inc.*, 369 F.3d 1, 4, 6 (1st Cir. 2004); *Kuper v. Iovenko*, 66 F.3d 1447, 1458-59 (6th Cir. 1995); *but see Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090 (9th Cir. 2004) (questioning whether there can ever be any such duty, but applying *Moench* to the case before it).

Here, while paying lip service to *Moench*, the Seventh Circuit ***in fact*** crafted a new standard; this standard is ***not*** based on ERISA and the cases construing it, but instead purports to be based on sources such as *The Modern Theory of Corporate Finance*[4] and *Principles of Economics*.[5] *See Summers*, 453 F.3d at 409. Whatever intellectual interest these sources may excite, they are nowhere embodied in the text of ERISA.

According to the *Summers* court, ***any*** argument that ESOP fiduciaries have a duty to sell based (as here) on the extraordinary

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4. Clifford W. Smith, Jr., ed. (2d Edition 1990).

5. N. Gregory Mankiw (1998).

and public collapse of a company ***must*** fail by virtue of a novel application of the "efficient market" theory: "at ***every*** point in the long slide of United's stock price, that price was the best estimate available either to State Street or to the Committee of the company's value, . . . so neither fiduciary was required to act on the assumption that the market was overvaluing United." *Summers*, 453 F.3d at 408 (emphasis in original). This *per se* "market-price" rule (that there can never be any duty to sell a publicly-traded stock where the market is efficient) stands in contrast to the *Moench* standard under which an ESOP plaintiff can prevail "by showing that a prudent fiduciary acting under similar circumstances would have made a different investment decision." *See Kuper*, 66 F.3d at 1459. The requirement to consider the surrounding circumstances, in turn, comes directly from the language of ERISA itself, which requires that ***all*** fiduciaries exercise "the care, skill, prudence, and diligence under the circumstances then prevailing." 29 U.S.C. § 1104(a)(1)(B).[6] Thus, the Seventh Circuit's *per se* "market price" rule finds no support in the statute, either.

Perhaps even more radically, the *Summers* court holds that a plan participant can ***never*** prevail in an ERISA "company stock" case ***unless*** he can prove he lacked substantial ***non-plan*** assets. *See* Pet. at 16-17. As the *Summers* court puts it, ERISA's prudence requirement ***can*** require the diversification of ESOP assets when the "risk" of company stock becomes "excessive" within the context of the participant's portfolio: "How excessive would depend in the first instance on the amount and character of the employees' other assets, for, as we have already indicated, it is the riskiness of one's portfolio, not of a particular asset in the portfolio, that is important to the risk-averse investor." *Summers*, 453 F.3d at 411.

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6. While State Street is correct that ESOP fiduciaries are, of necessity, not subject to the *per se* diversification requirement that applies to other ERISA plan investments, there is also no dispute that ESOP fiduciaries remain subject to the same duty of prudence under the circumstances that applies to all ERISA fiduciaries.

State Street knows that the requirement that non-plan assets be considered is both new and indefensible, as evidenced by its response; according to State Street, the Seventh Circuit somehow did not mean what it said in this portion of its opinion. SS Opp. at 27. Plaintiffs respectfully submit that this portion of the opinion cannot be expunged, and, indeed, is the reason why the Seventh Circuit affirmed summary judgment against them here. *See Summers*, 453 F.3d at 411 (judgment affirmed because "[t]he plaintiffs never sought to explore these issues" of how much wealth the plan participants had outside of the ESOP; hence, "there has . . . been a failure of proof.")

The Seventh Circuit's opinion in *Summers* has plainly created a split amongst the circuits with respect to the duty of ESOP fiduciaries.

B. Petitioners Properly Seek Reversal Of The Seventh Circuit's Decision

Respondent mistakenly suggests that the petition is "procedurally defective" since Petitioners seek "to affirm a holding of the lower court." SS Opp. at 12. To the contrary, Petitioners *lost* in the Seventh Circuit, and seek review of that decision upholding the district court's grant of summary judgment in favor of State Street. This is simply ***not*** a case like those cited by Respondent in which the litigant "was successful in the [court below] and has no right of appeal from the decree in its favor." SS Opp. at 12 (quoting *Pub. Sev. Comm'n v. Brashear Freight Lines, Inc.*, 306 U.S. 204, 206-07 (1939)).

Nonetheless, Petitioners acknowledge that the *Summers* court favorably resolved one issue upon which the Courts of Appeals differ. Namely, the Seventh Circuit sided with those courts that have held that so-called "directed trustees" are nonetheless subject to ERISA's fiduciary and co-fiduciary duties. In order to set forth the proper standard governing ESOP fiduciaries in this case, this Court will necessarily reach the same question. Unfortunately for Petitioners, however, that fact does *not* convert Petitioners into the "prevailing parties" in the

court below. It also does not render their petition "procedurally defective."

C. The Circuit Courts Are Split As To The Existence And Scope Of The Fiduciary Obligations Of Directed Trustees

In this case, Petitioners bring claims against State Street for breaches of the duties of prudence and loyalty under 29 U.S.C. § 1104(a), and co-fiduciary breaches under 29 U.S.C. § 1105(a). Though State Street claims that Petitioners never argued that "directed trustees" have the same fiduciary duties as other ERISA fiduciaries, SS Opp. at 12-13, Petitioners ***in fact*** stressed that argument. As Petitioners noted in the Seventh Circuit: "While State Street focused its defense on the assertion that it was a mere 'directed trustee' within the meaning of 29 U.S.C. § 1103(a)(1), the 'directed trustee' defense is no defense to Plaintiffs' claim for breach of co-fiduciary duty." *See, e.g, FirsTier Bank, N.A. v. Zeller*, 16 F.3d 907, 911 (8th Cir. 1994) (directed trustee "is not relieved of its fiduciary duties . . . to attempt to remedy known breaches of duty by other fiduciaries . . ."). Plaintiffs-Appellants', Cross-Appellees' Brief at 26. *See id.* at 33 (directed trustee has duty "to conform to the prudent man standard of care"). These arguments echoed the arguments made by Petitioners in the trial court.

Moreover, this Court cannot credit State Street's argument that the Circuit Courts are ***not*** divided as to the fiduciary obligations of directed trustees. The statute on its face suggests that the "named fiduciary" is responsible for making decisions in the first instance, yet makes clear that directed trustees are ***not*** to follow directions that are "contrary to ERISA." 29 U.S.C. § 1103(a)(1). Notwithstanding this language, some courts have held that "directed trustees" have ***no*** fiduciary duties whatsoever. *See Maniace v. Commerce Bank, N.A.*, 40 F.3d 264, 267 (8th Cir. 1994); *Herman v. NationsBank Trust Co.*, 126 F.3d 1354, 1361-62 (11th Cir. 1997). The Seventh Circuit here voiced its agreement with *FirsTier Bank, N.A. v. Zeller*, 16 F.3d at 911,

and squarely held that "[l]ike other ERISA trustees, a directed trustee has a statutory duty of prudence. § 1104(a)(1)(B)." *Summers*, 453 F.3d at 406.

Try though it might, State Street can not whitewash this very real split amongst the Courts of Appeals. Likewise, State Street cannot mask the importance of that split, which is well-illustrated by this case. Here, as is not unusual, the so-called "named fiduciaries" (the ESOP Committee members) were employees and pilots at UAL with no particular background in either finance or ERISA. State Street, the industry professional, attended each and every Committee meeting. Hence, State Street was well-aware that – even after the extraordinary and devastating events of 9/11, even after the unprecedented remarks by the C.E.O. that accurately reported that the Company was "hemorrhaging money," and was "in a struggle just to survive," and even as the financial community recognized a significant and short-term risk of bankruptcy – the Committee ***never even discussed*** the problems at the Company, the tanking stock price, or the implications for the billion-dollar ESOP over which the Committee ostensibly presided.[7] At the same time, albeit unknown to the Committee, State Street was well-aware of the burgeoning crisis at UAL and was monitoring the stock as an "at risk" position.[8] Yet, no doubt planning to hide behind its "directed trustee" status, State Street chose not to act until the stock was nearly worthless. Only then, in the late summer of 2002, did State Street choose to act – when it did so, and informed the Committee Members of their fiduciary obligations, State Street was ***almost immediately*** appointed investment manager for the ESOP.[9] In this capacity, State Street belatedly began selling off Company stock – far too little and far too late for the hapless ESOP participants, who lost some $500 million dollars as a result of State Street's dilatoriness. Stunningly in

7. *See* Petition at 4-10.

8. *See id.* at 9-10.

9. *See id.* at 10-11.

light of its holding, the *Summers* court concludes, "what State Street may well have done wrong was to delay selling its United stock until too late to spare the employee-shareholders from bearing inordinate risk." *Summers*, 453 F.3d at 411. Under the appropriate standard of prudence under the circumstances, Petitioners submit, they are entitled to a trial on precisely that question.

Hence, the split amongst the Courts of Appeals as to the fiduciary duties of directed trustees is one with very real consequences in a large number of currently pending cases.[10] The resolution of the conflict will provide much needed-guidance for the courts and for trustees, and may provide protection for ERISA plan participants.

D. The Department of Labor's Latest Pronouncement Has Exacerbated The Confusion Amongst the Lower Courts

State Street incorrectly asserts that "The Seventh Circuit's holding in *Summers* is consistent with . . . the position of the Department of Labor" in its 2004 Field Assistance Bulletin concerning the fiduciary responsibility of directed trustees with respect to ESOP investments. SS Opp. at 17 (discussing U.S. Dept. of Labor, Field Assistance Bulletin No. 2004-03 (December 17, 2004)) ("FAB"). To the contrary, the *Summers* court flatly rejected the FAB standard as "not administrable." *Summers*, 453 F.3d at 411.

Yet the FAB standard has become highly influential. Indeed, a growing number of courts purport to follow the FAB's statement that directed trustees have a duty to question the holding of company stock in an ESOP only "in limited, extraordinary circumstances, where there are clear and compelling public indicators . . . that call into serious question a company's viability as a going concern." FAB at 5-6. Those

10. Once again, State Street cannot change this indisputable fact by pointing to a small number of cases that have settled, or not yet reached the essential issue as to the duties of directed trustees. *See* SS Opp. at 28-29.

courts – including the district court in this case – view the FAB as conveying almost total immunity for directed trustees. *See, e.g., Summers v. UAL Corporation ESOP Comm.*, No. 03 C 1537, 2005 U.S. Dist. Lexis 23918, at *13-15 (N.D. Ill. October 12, 2005) (quoting the FAB as quoted in *In re WorldCom, Inc. ERISA Litigation*, 354 F. Supp. 2d 423, 445-48 (S.D.N.Y. 2005)); *see also DiFelice v. U.S. Airways, Inc.*, 397 F. Supp. 2d 735, 751-52 (E.D. Va. 2005) (citing the FAB and holding that there can be no duty to sell company stock until the company files for bankruptcy); *In Re RCN Litig.*, 2006 U.S. Dist. Lexis 12929, at *13-16 (D.N.J. Mar. 21, 2006).

In setting forth the correct standard governing the conduct of directed trustees of ESOPs, this Court can consider whether the DOL's latest statement is entitled to any deference whatsoever.

In fact, the FAB is a radical departure from a series of broad pronouncements made by the DOL over the years concerning the scope of the fiduciary duties of a "directed trustee." According to one such pronouncement, a directed trustee "has a responsibility to exercise discretion where the directed trustee has reason to believe that the named fiduciary's directions are not made in accordance with the terms of the plan or are contrary to ERISA. . . ." *In re Enron Corp. Sec. Derivative & ERISA Litig.*, 284 F. Supp. 2d 511, 593 (S.D. Tex. 2003) (quoting DOL Opinion No. 92-23A). According to another, "even with regard to directions involving stock that has been allocated to an individual participant's account, the Department has taken the position that the trustee(s) remain(s) responsible for determining whether a violation of ERISA would occur if the participant's directions were followed." *In re Enron*, 284 F. Supp. 2d at 593 (quoting DOL Opinion of Aug. 19, 1994). In the *Enron* litigation, the DOL filed an *amicus* brief, stating that: "even if Northern Trust [as a directed trustee] had no discretionary role under the Savings Plan, as it asserts, it could not follow directions that it knew ***or should have known*** were imprudent

or disloyal in violation of ERISA §§ 404(a)(1)(A) and (B), 29 U.S.C. §§ 1104(a)(1)(A) and (B)" (emphasis added).[11]

Plaintiffs submit that this Court should withhold deference to the FAB given that the DOL has radically changed its position without explanation. *See, e.g., Good Samaritan Hosp. v. Shalala*, 508 U.S. 402, 417 (1993); *Norfolk S. Ry. v. Shanklin*, 529 U.S. 344, 356 (2000). The DOL has made no attempt to explain its departure from its prior liberal reading of the duties of directed trustee in favor of the extremely narrow view of the new FAB. In the absence of any explanation, Plaintiffs submit that the FAB is entitled to no deference. *Atchison, T. & S. F. R. Co. v. Wichita Bd. of Trade*, 412 U.S. 800, 808 (1973). In any event, the question of whether the FAB standard should in fact trump the opinions of the Courts of Appeals is ripe for resolution by this Court in this case.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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11. A copy of the brief is available at *http://www.dol.gov/sol/media/briefs/enronbrief-8-30-02.pdf*